
CHAPTER V. INDEXING THE INCOME TAX BASE FOR INFLATION

INTRODUCTION

Unless the income tax is adjusted for inflation, rising prices increase real taxes on capital income, with some kinds bearing a greater burden than others. As explained in the next chapter, a consumption tax would not experience this problem because it would not tax income from capital. The problems posed by inflation can, however, be addressed directly within the framework of an income tax, either through ad hoc savings and investment incentives, like some of those in current law, or by indexing the income tax base for inflation. The necessary components of the tax base that would be indexed are capital gains, interest income and expense, depreciation, and costs of goods used from inventories.¹

Difference Between Bracket Indexing and Base Indexing

Inflation causes two distinct problems for an income tax, and separate kinds of indexing--bracket indexing and base indexing--are required for each to neutralize the tax to the effects of inflation--that is, to keep real tax liabilities constant when real incomes remain unchanged. The first problem, commonly called "bracket creep," affects income from labor (wages and salaries) and capital equally and arises because the basic graduated tax rate structure, personal exemptions, and zero-bracket amounts are all denominated in dollars whose real value erodes with inflation. During inflationary periods, nominal incomes that rise just enough to maintain constant purchasing power are pushed into higher income tax brackets, so that tax burdens rise by more than the inflation rate. The tax bracket indexation enacted in 1981 and scheduled to go into effect in 1985 will eliminate this bracket creep by periodically adjusting tax brackets, personal exemptions, and zero bracket amounts to keep them

¹ For very good, thorough explanations of the issues involved in indexing the income tax base for inflation, see Vito Tanzi, Inflation and the Personal Income Tax (Cambridge, England: Cambridge University Press, 1980); and Henry Aaron, ed., Inflation and the Income Tax, (Washington, D.C.: The Brookings Institution, 1976). Tanzi's book also provides descriptions of indexing techniques used in foreign countries.

in line with inflation.² Bracket creep would also be eliminated if the tax was made proportional rather than progressive.

Probably the more serious problem, and the one more difficult to correct, is the mismeasurement of income (or of the tax base) caused by inflation. This problem affects only income from capital and could be corrected by tax base indexing, the subject of this chapter. Tax base indexing would convert costs of earning investment income to current dollars (that is, dollars of the year in which the investment income is realized). When the restated costs were subtracted from the current dollar receipts to calculate taxable income, the result would then be an accurate measure of real income. Since investment expenditures are made before the resulting receipts are earned--often many years before--failure to measure capital expenditures and receipts in dollars of the same purchasing power causes capital income to be overstated and hence overtaxed during inflationary periods, even if bracket indexation or a flat-rate tax is in place.³ This problem arises when income is earned some time after an investment is made and, therefore, does not generally affect labor income, which is usually paid in the same year as work is done.

What Tax-Base Indexing Entails

Net taxable income is mismeasured during inflation because income from capital gains and interest income and expense are overstated, while depreciation and the cost of production goods taken from inventories are understated. Under tax-base indexing, these items would be measured at their real worth. Although depreciation and the cost of inputs taken from inventories figure more prominently in the determination of corporate than

2 Bracket indexation is discussed in Congressional Budget Office, Indexing the Individual Income Tax for Inflation (September 1980). For an explanation of the bracket indexing that will become law in 1985, see Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981 (H.R. 4242, 97th Congress: P.L. 97-34) (December 31, 1981), pp. 38-40.

3 This problem occurs whenever there is inflation, even if the rate of inflation is declining. Whenever there is inflation, capital income is overtaxed in the sense that it is taxed at a higher rate than if there were no inflation. To the extent that tax preferences for capital income compensate for the effects of inflation, there may actually be little or no overtaxation of some capital income, but the rates of tax may vary widely among investments, leading to misallocations of capital and inequities in taxation.

individual income, they do affect the individual income tax because individuals are taxed on dividends and on business income from self-employment and partnerships. Because capital gains and interest income are more important overall for individual income taxation, this chapter focuses on them and only briefly surveys the problems inflation poses for depreciation and inventory tax accounting.

Tax-base indexing is not meant to compensate investors for losses incurred as a result of inflation. Rather, it is intended to restore the income tax to what it would be in the absence of inflation, so that only investment returns that represent real increases in purchasing power are taxed. Although inflation may push up nominal interest rates and reduce the real value of bonds carrying lower interest rates, for instance, tax-base indexing is not intended to compensate bondholders for these losses. The indexing simply ensures that taxpayers are allowed to deduct these real losses, just as they would if there were no inflation and they sold bonds for less than the purchase price.

Evaluation of Base Indexing Considering Tax Preferences for Capital Income

It is difficult to assess the merits of tax-base indexing because the current income tax departs in so many ways from a pure, "neutral" income tax, even when there is no inflation. Since tax-base indexing essentially restores the income tax to the tax that would be in place were there no inflation, it cannot be evaluated independently of other tax provisions. If the current income tax were ideal in every respect other than that its base was not indexed for inflation, tax-base indexing would unambiguously confer efficiency and equity gains.⁴ Regardless of the inflation rate, tax would then be imposed uniformly on all real income.

As discussed in Chapter III, the current income tax departs from the ideal not only because its base is not indexed for inflation, but also because the corporate and individual income taxes are not integrated and there are many tax preferences for capital income. Some have argued that the tax preferences for capital income amount to an imprecise indexing of all of the necessary tax base items except interest income and expense.⁵

⁴ These gains would be greater the higher, more unpredictable, and more persistent the inflation, and the higher and more progressive the marginal tax rates.

⁵ "... This is not to argue that the real returns from holding other than interest-bearing assets are immune to inflation, but rather that the

Some of the more important tax preferences for saving and investment are considered below when they are relevant to the discussions on indexing capital gains, interest income and expense, depreciation, and inventories. Because of the uncertainty about which, if any, of the tax preferences would be repealed if tax-base indexing were adopted, the conclusions drawn in other chapters about the efficiency, equity, and simplicity effects of a tax change are not easy to draw for tax-base indexing.

CAPITAL GAINS

Tax is currently imposed on 40 percent of nominal capital gains, which are the difference between the sale and purchase prices of assets.⁶ Thus, some tax is collected (and some would be collected even if tax brackets were indexed) on the sale of an asset that appreciated at just the inflation rate. Since in real terms that asset did not appreciate at all, it produced no real income, and no tax would be collected on its sale if the income tax base were indexed for inflation. Capital gains indexation simply adjusts the tax base so that taxpayers are exempted from paying tax on the portion of nominal gain needed to maintain the purchasing power of their initial investment. With indexation, therefore, tax is imposed only on real gains--increases in real net worth--and not on nominal gains resulting only from inflation.

Even when there is little or no inflation, nominal capital gains can greatly exceed real gains as a result of previous high inflation. For example, even though there had been no inflation for five years, an asset held for ten years and sold at a nominal gain of 60 percent would not have

various forms of exclusion, deferral, and other tax reduction have the effect of providing at least an ad hoc form of indexing to most other forms of capital income, albeit in an imperfect, uneven and haphazard way." (Harvey Galper and Eugene Steuerle, "Tax Policy and Savings," presented at the Annual Southern Economic Association Meeting, 1981, p. 30.)

- 6 This discussion is confined to capital gains on noninterest-bearing and nondepreciable assets. Indexing the other gains is discussed below in the sections on indexing interest and depreciation for inflation. For an excellent explanation of capital gains indexing and the tax preferences for capital gains, see Roger Brinner and Alicia Munnell, "Taxation of Capital Gains: Inflation and Other Problems," New England Economic Review (September/October 1974), pp. 3-21.

appreciated at all in real terms if the annual inflation rate during the first five years had been 10 percent ($(1.10)^5 = 1.60$).⁷

Mechanics of Capital Gains Indexation

Indexing capital gains requires one additional calculation per transaction compared to current law. Before gain is calculated, the purchase price of an asset must be converted to the price level prevailing at the sale date. The purchase price is converted by multiplying it by the ratio of the general price level at the sale date to the general price level at the purchase date. (The IRS would publish tables of the conversion factors for different purchase and sale dates.) The resulting adjusted purchase price is then subtracted from the sale price to determine the gain on which tax is assessed.

For example, if an asset is purchased for \$100 and sold a year later for \$115, and if inflation is 10 percent during the year, the real gain is \$5.

⁷ The taxation of capital gains is most distorted when high rates of inflation persist over long periods of time, but it is also distorted during prolonged periods of relatively low inflation. The price level doubles after ten years of 7 percent annual inflation (12 years of 6 percent inflation or 15 years of 5 percent inflation), for instance, so real capital gains are experienced then only on assets sold for more than twice their nominal purchase price.

Between December 1974 and December 1981, the 500 stocks represented in the Standard and Poor's composite index rose in nominal value by 85 percent, while the CPI rose by 81 percent over the same period. (This is equivalent to 7 years of 8.9 percent annual inflation.) (Economic Report of the President (February 1982), pp. 291, 337; and (January 1976), pp. 220, 266.) Had the portfolio represented by the Standard and Poor's index been purchased at the beginning of this period and sold at the end, its owner would have had to pay tax of 9 percent of the value of the portfolio, more than the increase in the portfolio's purchasing power. (This assumes that the owner was in the 50 percent tax bracket.)

A study of the actual capital gains reported on a sample of 30,000 tax returns in 1973 concluded that the aggregate nominal gains of \$4.63 billion that were reported correspond to real losses of \$910 million. (Martin Feldstein and Joel Slemrod, "Inflation and the Excess Taxation of Capital Gains on Corporate Stock," National Tax Journal (June 1978), p. 110.)

This is calculated by converting the \$100 purchase price into the dollars prevailing at the time of sale:

$$\text{Real Gain} = \$115 - (\$100 \times 1.1) = \$115 - \$110 = \$5.$$

At the end of the year, the asset's owner needs to recover \$110 just to maintain the purchasing power of his initial investment; only amounts in excess of \$110 represent an increase in real command over goods and services. If capital gains were indexed, tax would be due only on the \$5 real gain in this example. Under current law, tax in this case would be imposed on \$6, which is 40 percent of the nominal gain of \$15.

Table 12 illustrates the calculation of indexed capital gains for several examples, including the one just described which appears in row 7. All examples assume asset owners are in the 50 percent tax bracket. The examples are grouped into three sets showing the effects of inflation rates of zero, ten, and fifteen percent. The table shows that, under current law, tax is sometimes collected on the sale of assets that lost value in real terms (that is, whose prices failed to keep pace with inflation). This occurs in the table when the entry in Column 7, "Tax Due Under Current Law," is positive even though the entry in Column 6, "Indexed (Real) Capital Gain" is negative. In these and some other cases, the tax due exceeds the entire real capital gain, so that tax rates on real gains exceed 100 percent (see entries reading "over 100" in Column 8, "Tax Due As Percent of Real Gain"). The top set of examples is based on an inflation rate of zero and illustrates that, when there is no inflation, capital gains are taxed at much less than the 50 percent rate applying to other income of the taxpayers in these examples.

Tax Preferences for Capital Gains

In theory, income is earned when net worth increases, which occurs not all at once on the sale of an asset but gradually whenever the asset appreciates. Ideally, then, capital gains should be taxed as they accrue, and not only upon sale. Taxing only on sale, as under current law, allows owners to defer payment of tax, which has the effect of lessening the tax burden, since the tax can earn interest between the time it should theoretically be paid and the time the law requires it to be paid.⁸

⁸ Taxing gains only on sale also allows taxpayers to time the realization of gains and losses to minimize taxes. Under a graduated-rate tax, taxpayers benefit by selling at a gain (realizing gains) when they are in low tax brackets. They can realize losses and reduce tax liabilities while holding appreciating assets for a longer period. The appreciation

Ideally, taxpayers would include in taxable income 100 percent of real (indexed) capital gains on accrual and the allowed full deductibility of real losses. Compared to this theoretical ideal, current law both overtaxes capital gains, because the gains are not indexed for inflation, and undertaxes them, because only 40 percent of nominal gains is taxed and then only on sale rather than on accrual of gains.

Certainly neither the capital gains exclusion nor taxation on sale rather than accrual was enacted solely as a substitute for capital gains indexation, although Congress increased the exclusion from 50 to 60 percent in 1978 partly to offset the effects of inflation.⁹ Nevertheless, the tax preferences for capital gains should be considered in an evaluation of capital gains indexation.

on assets held until death escapes income taxation completely, since the heir's tax basis is the asset's value on inheritance (called "stepped-up basis").

Ideally, capital losses should be fully deductible as they accrue, mirroring the ideal treatment of capital gains. Currently, taxpayers are sharply limited in the amount of net capital loss that they can deduct annually. If capital gains and losses were taxed on accrual, this kind of limitation would not be necessary because there would no longer be a tax advantage in realizing losses and deferring gains.

- ⁹ Joint Committee on Taxation, General Explanation of the Revenue Act of 1978, P.L. 95-600 (March 12, 1979), p. 252. Inflation has increased the tax rate on real capital income over the past 25 years, but Congressional ad hoc tax reductions, such as the capital gains tax reduction, were motivated partly by a desire to offset the effects of inflation. Opinions on Congressional motivations and their relevance differ widely. For example, see Martin Feldstein and Lawrence Summers, "Inflation and the Taxation of Capital Income in the Corporate Sector," National Tax Journal (December 1979), pp. 445-470; Jane Gravelle, "Inflation and the Taxation of Capital Income in the Corporate Sector: A Comment," National Tax Journal (December 1980), pp. 473-483; and Martin Feldstein and Lawrence Summers, "Inflation and the Taxation of Capital Income in the Corporate Sector: Reply," National Tax Journal (December 1980), pp. 485-488.

TABLE 12. CALCULATION OF INDEXED (REAL) CAPITAL GAIN AND TAX DUE UNDER CURRENT LAW AND AS PERCENTAGE OF REAL GAIN^a

(1) Nominal Sale Price (In dollars)	(2) Nominal Purchase Price (In dollars)	(3) Nominal Gain ((1)-(2)) (In dollars)	(4) Inflation Rate (In percents)
95	100	-5	0
100	100	0	0
105	100	5	0
110	100	10	0
105	100	5	10
110	100	10	10
115	100	15	10
120	100	20	10
110	100	10	15
115	100	15	15
120	100	20	15
125	100	25	15

(Continued)

- a. Examples assume assets are held for one year and owners are in the 50 percent tax bracket.

TABLE 12. (Continued)

(5) Adjusted Purchase Price ^b (In dollars)	(6) Indexed (Real) Capital Gain ((1)-(5)) (In dollars)	(7) Tax Due Under Current Law ^c (In dollars)	(8) Tax Due Currently As Percentage of Real Gain ((7)/(6))
100	-5	-1	20
100	0	0	20
100	5	1	20
100	10	2	20
110	-5	1	over 100 ^d
110	0	2	over 100 ^d
110	5	3	60
110	10	4	40
115	-5	2	over 100 ^d
115	0	3	over 100 ^d
115	5	4	80
115	10	5	50

- b. Adjusted purchase price is nominal purchase price multiplied by the ratio of the price level at the end of the year to the price level at the beginning of the year.
- c. Tax is due on 40 percent of nominal gain. In the example of the third row, tax is due on \$2 (40 percent of \$5), so \$1 tax is due (since the owner is assumed to be in the 50 percent tax bracket).
- d. Tax due exceeds 100 percent of the real gain.

Net Effect of the Current System

For any given transaction, the theoretically ideal tax treatment outlined above can be replicated by taxing only a percentage of nominal capital gains on sale. (For asset values that failed to keep up with inflation, these percentages would be negative, reflecting the fact that the assets were sold at real losses.) The percentage that would be taxed--the inclusion factor--would be different for each transaction, and would vary depending on the inflation rate, the real rate of asset appreciation, and the length of time that the asset had been owned. It is possible to calculate ideal inclusion factors for a variety of inflationary conditions. If the ideal inclusion factors were all very close to 40 percent (the inclusion factor currently in the law), one could conclude that current law approximates the ideal tax treatment.¹⁰

If there were no inflation and an asset were held only one year, the ideal inclusion factor would be 100 percent, more than double the current inclusion factor of 40 percent. There would be no need to tax less than 100 percent of nominal gains as an inflation adjustment since there had been no inflation, and there would be no need to charge extra tax to make up for the deferral advantage of taxing on sale rather than on accrual since, with a holding period of only one year, taxation on sale would be roughly equivalent to taxation on accrual. If an asset appreciated at just the inflation rate, the ideal inclusion factor would be zero, regardless of the inflation rate or how long the asset was held. In this case, a 40 percent inclusion rate is far too large.

Table 13 shows the wide range of ideal inclusion factors for different investments made by a taxpayer in the 50 percent tax bracket. For a 4 percent real rate of capital appreciation (see the upper half of the table), ideal inclusion factors range from 27 percent for assets held only one year when the inflation rate is 12 percent to 123 percent for assets held 25 years when there is no inflation.¹¹ (The range of ideal inclusion factors would be wider if the table showed values for inflation rates above 12 percent and holding periods longer than 25 years.) The lower half of Table 13 indicates that ideal inclusion factors would be considerably lower for

¹⁰ Actually, there is no fixed inclusion factor under which taxpayers would behave as they would under the ideal tax treatment of capital gains. As long as there is a fixed inclusion factor and gains are taxed on realization, taxpayers have an incentive to defer realization.

¹¹ The real rate of appreciation is the rate over and above that needed to maintain the purchasing power of the initial investment. The real rate of appreciation would be 4 percent, therefore, if the nominal rate of appreciation was 12 percent and the inflation rate 8 percent.

TABLE 13. PERCENTAGE OF NOMINAL CAPITAL GAINS THAT WOULD BE TAXED ON SALE UNDER THEORETICALLY IDEAL TAX TREATMENT OF CAPITAL GAINS^a

Holding Period (In years)	Inflation Rate (In percents)			
	0	4	8	12
<u>Real Rate of Appreciation of 4 Percent</u>				
1	100	51	35	27
5	104	57	42	35
10	109	65	51	45
15	114	73	61	56
25	123	90	81	79

<u>Real Rate of Appreciation of 1 Percent</u>				
1	100	21	12	9
5	101	22	14	11
10	102	25	17	14
15	103	28	20	17
25	106	33	26	24

SOURCE: Congressional Budget Office calculations based on methodology presented in Roger Brinner, "Inflation, Deferral, and the Neutral Taxation of Capital Gains," National Tax Journal (December 1973), pp. 565-573.

- a. Investor is assumed to be in the 50 percent tax bracket. When the asset is assumed to appreciate at a real rate of 4 percent annually, the nominal appreciation rates for this asset would be 4, 8, 12, and 16 percent for inflation rates of 0, 4, 8, and 12 percent, respectively. For any given inflation rate and holding period, inclusion factors would be lower for lower real rates of return and slightly higher for lower marginal tax rates.

assets that appreciated at a real rate of only 1 percent instead of the 4 percent rate assumed in the upper half of the table.¹²

Table 13 shows that no single inclusion factor can replicate the theoretically ideal tax treatment of capital gains under all plausible, or even all likely, circumstances.

Implementation of the Ideal Tax Treatment of Capital Gains

Taxation of 100 percent of real (indexed) capital gains on accrual would complicate the income tax. Accrual taxation is probably administratively infeasible because of valuation and liquidity problems (see Chapter III), but it could be approximated by taxing only on sale or death and assessing an extra charge for deferral, based on the length of the time the asset was held.¹³ The IRS could publish the interest fees charged for deferral in the same table as the adjustment factors for inflation indexing. Figure 1-A illustrates an example of a revised capital gains tax form that

¹² Some tax reform proposals would attempt to compensate for the effects of inflation by exempting varying percentages of gain from taxation, with the exempt percentage increasing with the duration of ownership. Since, as shown in Table 12, ideal inclusion rates increase, rather than decrease, with the holding period, this is not a correct approach to the problem.

¹³ See Roger Brinner, "Inflation, Deferral, and the Neutral Taxation of Capital Gains," National Tax Journal (December 1973), pp. 565-573; and James Wetzler, "Capital Gains and Losses," in Joseph Pechman, ed., Comprehensive Income Taxation (The Brookings Institution, 1977), pp. 115-162.

Taxation on accrual would be feasible for regularly traded assets such as common stock. The Canadian Minister of Finance proposed establishing special accounts for the purchase of stock beginning October 1, 1983. The stock would be valued annually and owners would be taxed each year on the annual change in the real value of their accounts. (Tax due would be paid over a four-year period.) This proposal would thus combine indexation with taxation on accrual, but only for shares of common stock held in these special accounts. (Allan MacEachen, Deputy Prime Minister and Minister of Finance, Inflation and the Taxation of Personal Investment Income (Canada: Department of Finance, June 1982), pp. 31-35; and Marc Lalonde, Minister of Finance, The Indexed Security Investment Plan (Canada: Department of Finance, April 1983).)

FIGURE 1-A. POSSIBLE REVISION OF SCHEDULE D FOR LONG-TERM CAPITAL GAIN TAXATION (In dollars)

CURRENT FORM					
PART II. Long-Term Capital Gains and Losses--Assets Held More Than One Year					
a. Kind of Property and Description (Example, 100 shares of "Z" Corp.)	b. Date Acquired (Mo., Day, Year)	c. Date Sold (Mo., Day, Year)	d. Gross Sales Price Less Expense of Sale	e. Cost or Other Basis, As Adjusted	f. Gain (or Loss)
100 shares, "Z" Corp.	Mar. 4, 1973	Nov. 22, 1981	280	130	150

REVISED FORM							
PART II. Long-Term Capital Gains and Losses--Assets Held More Than One Year							
a. Kind of Property and Description (Example, 100 shares of "Z" Corp.)	b. Date Acquired (Mo., Day, Year)	c. Date Sold (Mo., Day, Year)	d. Gross Sales Price Less Expense of Sale	e. Cost or Other Basis, As Adjusted	f. Cost Multiplied by Inflation Adjustment	g. Inflation-Adjusted Gain (d minus f)	h. Gain Multiplied by Interest Adjustment ^a
100 shares, "Z" Corp.	Mar. 4, 1973	Nov. 22, 1981	280	130	254	26	28

SOURCE: Congressional Budget Office update of Roger Brinner and Alicia Munnell, "Taxation of Capital Gains: Inflation and Other Problems," New England Economic Review (September/October 1974), Figure 1, pp. 18-19.

a. Indexed taxable gain including the appropriate interest charge for deferral.

FIGURE 1-B. TABLE TO ACCOMPANY REVISED SCHEDULE D

Date of Purchase	(1) Inflation Adjustment	(2) Interest Adjustment	Date of Purchase	(1) Inflation Adjustment	(2) Interest Adjustment
1939	6.262	1.461	Jan. 1978	1.392	1.024
1940	6.202	1.452	Feb. 1978	1.383	1.024
1941	5.907	1.442	Mar. 1978	1.372	1.024
1942	5.338	1.432	Apr. 1978	1.360	1.024
1943	5.029	1.422	May 1978	1.348	1.024
1944	4.943	1.412	June 1978	1.334	1.024
1945	4.833	1.402	July 1978	1.324	1.024
1946	4.453	1.392	Aug. 1978	1.317	1.024
1947	3.894	1.382	Sept. 1978	1.307	1.024
1948	3.613	1.371	Oct. 1978	1.297	1.024
1949	3.648	1.360	Nov. 1978	1.290	1.024
1950	3.613	1.350	Dec. 1978	1.284	1.024
1951	3.348	1.339			
1952	3.277	1.328	Jan. 1979	1.273	1.012
1953	3.252	1.318	Feb. 1979	1.258	1.012
1954	3.236	1.307	Mar. 1979	1.246	1.012
1955	3.248	1.295	Apr. 1979	1.232	1.012
1956	3.200	1.284	May 1979	1.217	1.012
1957	3.090	1.273	June 1979	1.203	1.012
1958	3.008	1.262	July 1979	1.190	1.012
1959	2.984	1.250	Aug. 1979	1.178	1.012
1960	2.937	1.239	Sept. 1979	1.166	1.012
1961	2.907	1.227	Oct. 1979	1.156	1.012
1962	2.875	1.216	Nov. 1979	1.145	1.012
1963	2.841	1.204	Dec. 1979	1.133	1.012
1964	2.804	1.193			
1965	2.757	1.181	Jan. 1980	1.117	1.000
1966	2.680	1.169	Feb. 1980	1.102	1.000
1967	2.605	1.157	Mar. 1980	1.086	1.000
1968	2.500	1.145	Apr. 1980	1.074	1.000
1969	2.372	1.133	May 1980	1.064	1.000
1970	2.240	1.121	June 1980	1.052	1.000
1971	2.148	1.109	July 1980	1.051	1.000
1972	2.079	1.097	Aug. 1980	1.045	1.000
1973	1.957	1.085	Sept. 1980	1.035	1.000
1974	1.764	1.073	Oct. 1980	1.026	1.000
1975	1.616	1.061	Nov. 1980	1.017	1.000
1976	1.528	1.049	Dec. 1980	1.008	1.000
1977	1.435	1.037			

could be used for this purpose and Figure 1-B provides a table of the inflation and interest adjustments to accompany it. The last column (h) in the revised form shows the indexed taxable gain including the appropriate interest charge for deferral.

Pros and Cons of Indexing Capital Gains and Repealing Tax Preferences for Capital Gains

The complexity and administrative burden of the revised tax form and table needed to implement the ideal tax treatment of capital gains have to be weighed against the imprecision of current law. In addition, as explained in the conclusion to this chapter, some argue that capital gains should not be indexed for inflation unless interest expense is also indexed.

Capital gains indexing could be enacted without changing the tax treatment of capital gains in any other way, rather than as part of the complete revamping just discussed. Indeed, the Senate version of the Tax Equity and Fiscal Responsibility Act of 1982 would have indexed capital gains without otherwise changing their tax treatment.

Several arguments can be made in favor of retaining the exclusion of 60 percent of long-term capital gains from taxation and the tax exemption of gains on assets given to charity or held until death. These provisions can be considered a general investment incentive or a means of moderating the double taxation of dividends--or what some analysts feel is the overly heavy rate of tax on savings inherent in income taxation. On the other hand, other arguments currently used to support the provisions would be invalidated if capital gains were indexed and a charge for deferral was imposed. The preferences could no longer be considered a substitute for explicit indexation, nor would they be needed to counteract the discouragement of selling and reinvesting caused by taxing capital gains only on sale.¹⁴

INTEREST INCOME AND EXPENSE

When there is no inflation, interest receipts represent an increase in real net worth. Thus, they fit the definition of income and should be taxed

¹⁴ Turnover of investments is discouraged (so investment is "locked in") when capital gains are taxed only on sale, since it pays to sell and reinvest only when a new investment is expected to return enough more than the old to pay the capital gain tax. Any reduction in the tax rate on capital gains, therefore, encourages turnover.

in full to the recipient (whether an individual under the individual income tax or a corporation under the corporate income tax). Interest paid by a business is a cost of doing business which should be deductible in full to compute the net income on which tax is due, as long as there is no inflation. (Amounts paid in interest reduce the business owner's command over goods and services.) Consumer durable and mortgage interest payments pose a more complicated problem. In the absence of inflation, they should be deductible in full, but the imputed income provided by the goods that they finance should be taxed (see Chapter III).¹⁵

The Problem

In the absence of inflation, the rate of individual income tax on interest income ranges from 12 percent to 50 percent--the range of marginal rates. Rates of tax exceeding 100 percent can occur during inflationary periods, however, because all nominal interest is taxed, even though much--sometimes most--of that interest is not interest at all, but rather additional payments required to keep intact the purchasing power of the investor's principal. In these circumstances, the income tax is in essence partly a tax on the principal. The degree to which principal is taxed depends on the investor's marginal tax rate, the rate of inflation, and the interest rate. By the same token, because borrowers are allowed to deduct all nominal interest paid, in many cases they can deduct much more than 100 percent of real interest paid--the government, in effect, pays part of the principal on their loans.

Inflation erodes the real value of debt, reducing borrowers' real liabilities and commensurately reducing the value of lenders' assets as measured by their command over goods and services. When interest income and expense are indexed for inflation, the tax system effectively recognizes these gains and losses resulting from changes in the general price level.

¹⁵ Since this imputed income (such as the rent that a homeowner would have to pay to live in his house if he did not own it) is not currently taxed, consumer and mortgage interest paid by individuals arguably should not be deductible. Since disallowing these interest deductions would not remove the tax advantage of those who own their homes outright (since they would continue to receive imputed rental income tax-free), however, it would effectively discriminate against homeowners with mortgages. For a complete discussion, see Richard Goode, The Individual Income Tax (The Brookings Institution, 1976), pp. 117-125.